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**Bradley E. Rock**  
*Chairman of the Board, President  
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January 31, 2006

Board of Governors of the  
Federal Reserve System  
20<sup>th</sup> Street and Constitution Avenue, N.W.  
Washington, DC 20551

Attention: Ms. Jennifer J. Johnson  
Secretary

Re: Docket No. OP – 1248

Dear Ms. Johnson:

We are writing to comment upon the proposed guidance entitled, "Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices", and identified by the above-referenced Docket No. OP-1248. Our bank is a state-chartered bank which is a member of the Federal Reserve System.

While we understand and agree with some of the Agencies' concerns expressed in the proposal, we believe that others are unwarranted and that these particular proposed new requirements would mark a major step in the direction of government forcing a large number of community banks to sell themselves to larger banks due to an inability to operate profitably in a regulatory environment designed to put them at an extreme disadvantage.

More specifically, we agree with the idea that having too many loans that present similar types of risk constitutes a "concentration" of risk that ought to be avoided. Nonetheless, we strongly disagree:

- with the incorrect premise that all business loans secured by mortgages on real estate present similar kinds of risks and, therefore, should be considered a single "concentration" of loans for the purpose of evaluating credit risk;
- with the incorrect premise that loans secured by mortgages on real estate constitute a greater risk of loss to banks than loans that are not secured by mortgages;

- with the conclusion (drawn from these two incorrect premises) that community banks with a large number of real estate loans should be required to hold higher levels of capital than other banks because they present a riskier profile;
- with the further conclusion that community banks with a large number of real estate loans should be required to hold higher levels of loan loss reserves than other banks because they present a riskier profile; and
- with the amount of time, money, effort and paperwork that community banks should be required to do to disprove the assumption that they have an unsafe “concentration” of real estate loans.

### Background

A shift by community banks in recent years toward increased commercial real estate lending is quite understandable when viewed in light of various market developments. As Chairman Greenspan noted in a speech to a banker convention on March 17, 2004, in San Diego, rather than constitute a dangerously risky trend among a few banks, “such credit exposures are a natural evolution of community banking.”

Community banks have been gradually squeezed out of being able to do significant volumes of most types of consumer lending. Auto lending has been dominated by the captive finance companies at the point of sale. Credit card lending has become dominated by those companies with only the largest mass media and processing capabilities. Realtors capture residential mortgage prospects at the point of sale, while bankers are prohibited from doing so. Other types of consumer lending are often absorbed by the large credit unions who use their tax-exempt status to price below their smaller community bank competitors.

It is true that some avenues for commercial lending not secured by real estate remain available to community banks, but those are much riskier than loans secured by real estate. Obviously, unsecured business lines of credit are much riskier, especially for the types of small businesses that gravitate toward community banks. Similarly, any experienced banker or bank lawyer knows that defaulted loans secured by receivables or inventory rarely result in meaningful recoveries. Even business loans secured by equipment often result in little or no recovery upon default because failing businesses frequently allow the equipment to deteriorate or the owners move more useful equipment to unknown locations.

So, quite naturally, community banks have moved toward doing more of the safest type of lending that remains available to them: loans secured by real estate. But these loans hardly constitute a single type of loan.

Premise that all business loans  
secured by real estate constitute  
a single "concentration" of risk

In our bank, which is a 96 year-old community bank with approximately \$875 million in assets, we have or have had the following types of loans:

1. A line of credit secured by a mortgage on a small office building in Smithtown, Suffolk County, that houses a medical practice run by a small group of doctors. The doctors use the line to operate the practice while they wait for the sometimes slow payments from medical insurance carriers.
2. A construction loan secured by a mortgage on an apartment building in Williamsburg, Brooklyn. The funds are used to finance renovation of the apartments and their conversion into condominiums.
3. An amortized permanent mortgage loan on a 175-acre private golf club in Baiting Hollow on the east end of Long Island.
4. A construction loan to build a single-family, custom residence in Brookville on the north shore of Long Island in Nassau County. The builder has a contract with the buyer, and the buyer has a permanent mortgage commitment.
5. An amortized permanent mortgage loan on a fully-tenanted 13-unit multi-family brownstone located on the upper East side of Manhattan.
6. An amortized permanent mortgage loan on a 3.4 acre parcel in Hicksville in Nassau County improved with buildings housing a national chain drug store and national chain fast food restaurant.
7. A construction loan for a small, five lot subdivision in Bellport on the south shore of Long Island. The builder must have a contract with the buyer and the buyer must have a commitment for a permanent mortgage loan.
8. An amortized permanent mortgage on small, two-story office building in Port Jefferson on the north shore of Suffolk County. The tenants are mostly lawyers and accountants in one and two-person practices.

All eight of these loans are business loans secured by mortgages on real estate, but they are

nonetheless a very diversified group of loans. Most importantly, the risk of non-payment of these loans is not “concentrated” at all because it depends upon widely divergent circumstances. The first depends upon the continued success of an established medical practice in western Suffolk County. The second depends upon the skill of the builder, our supervision of the renovation process, and the market for condominiums and/or apartments in the Williamsburg section of Brooklyn. The third depends upon the number of public and private golf clubs on the east end of Long Island, the relative quality and costs of the clubs, and the continued desire of people in the metropolitan area to use the east end of Long Island for recreation. The fourth depends upon the skill of a builder of a custom home on the north shore of Nassau County, and our supervision of the advances. The fifth depends upon the payment stream from the rents of 13 different tenants in Manhattan, the individual owner’s income and assets, and the unlikelihood that the owner would ever risk losing his equity in the property before selling it himself. The sixth depends upon the continued success of a retail drug store and fast food restaurant, similar competition in the area in Nassau County, and so on.

These loans are diversified by geography, by loan type and by repayment sources. It is undeniably clear that they do not present a single, concentrated risk. And it is also abundantly clear that any system of analysis that lumps these loans together and classifies them as presenting a single type of risk is inherently flawed.

Premises that loans secured by  
mortgages on real estate present  
a greater risk of loss than  
loans that are not secured by mortgages

For the loan to the medical practice noted above, would the bank be safer if the line were not secured by the mortgage? Of course not, but under the proposed guidance, if the line of credit were not so secured, it would not be included in the calculation of a real estate “concentration”, and the bank would be deemed safer.\*

Even more importantly, if our bank were to choose not to do the construction loans or permanent mortgage loans listed, and were instead to replace them with a similar amount of unsecured lines of credit to card stores and other small businesses of the type you find in suburban shopping centers and office parks, would the bank then have less risk of loss? Or if

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\* We realize that some of these types of loans might fall within an “owner-occupied” exception, but many would not. While we understand and appreciate that a proposed owner-occupied exception is a recognition of one of the difficulties that we are pointing out, we also believe that a full exploration of the legal details of such an exception are beyond the scope of what should be addressed in this comment letter.

the bank were to replace those mortgage loans with a similar amount of credit card debt, would the bank have less risk of loss then? Not at all. Quite to the contrary, banks are almost certain to lose all or most of the principal when the unsecured lines or credit card debt goes into default. But for loans secured by mortgages on real estate, even if the property deteriorates or the appraiser made an overestimate of the property's value, there will still be value in the property upon recovery, and only part of the principal will be lost even in the worst case.

Consider how much has to go wrong before there is a substantial loss of principal on a typical community bank loan secured by a mortgage. Most loans are made on a loan-to-value ratio of 75% or less, and most loans are paid for some time before they go into default, meaning that some principal has been repaid, creating an even wider equity cushion. A deterioration in the condition of the property or an overestimate of value by the appraiser would typically have to reduce the value of the property by more than 30% before the bank would lose its first dollar of principal. Even in the worst of times, an appraisal overestimate of more than 40% on a small property is rare. And in that rare event, the bank would still lose only 10% of the principal, a far cry from the often 100% loss on an unsecured loan.

We fully understand that if, for example, a bank was making many loans on large 100,000 square foot office buildings in a small geographic market that there would be an inordinate concentration of credit risk, and that the potential losses on larger properties are larger for several reasons. But for the community banks that would be hit hardest by this proposal, they are not making those kinds of loans.

Conclusion that community banks with  
a large number of real estate loans  
are less safe than other banks and,  
therefore, should be required to hold  
higher levels of capital than other banks

We believe that this issue is closely-related to the Basel IA discussion and goes to the heart of the future of community banking. Market forces and government regulation have pushed community banks into a position where one of the only channels left for making a profit sufficient to satisfy investors is commercial real estate lending. But if community banks are now required to hold much higher levels of capital against their assets (and, in some cases, against the exact same types of loans), it would likely sound the death knell for community banks with investors. If group A banks are required to hold 12% capital against certain commercial real estate loans and group B banks need only hold 6% capital against the same loans, group A banks will either be forced to price much higher than group B (and probably lose all of that business to the significantly lower prices), or group A banks will be forced to match the group B pricing and produce a 50% lower return on shareholder equity. It would not take long for investors to observe the differences, and group A banks would be compelled to sell to larger banks who can afford to pay and who have the benefit of the lower capital

requirements. Unwise government regulation will have forced further consolidation of the industry.

Conclusion that community banks with  
a large number of real estate loans  
are less safe than other banks and,  
therefore, should be required to hold  
higher levels of loan loss reserves than other banks

The notion that a loan secured by real estate is riskier is, quite simply, a false premise. Both common sense and experience indicate that the risk of loss on these loans is lower than the risk of loss on other loans. Imagine two \$500,000 loans to the same borrower, one secured by a mortgage on real estate valued at \$750,000 and the other unsecured. If the borrower's financial condition deteriorates to a point where we anticipate that he may stop making his payments on both loans, should we expect the same loss on both loans and hold the same level of reserves against both? Of course not. To do so would be foolish. It is much more likely that we will have much less of a loss (if any loss at all) on the loan secured by real estate. So why should we be required to hold higher levels of reserves in the aggregate against these loans? Such a proposal does not make sense.

Furthermore, if community banks with a large number of real estate loans are required to hold higher levels of loan loss reserves, it would exacerbate an already existing problem, perhaps to a breaking point. For some time now, the accounting industry (and to some extent, the SEC) have been advocating an "incurred loss" model for bank loan loss reserves as opposed to an "expected loss" model. Accounting firms are jittery about lawsuits these days and they would much rather not have to make a judgment in connection with the audit that the amount of reserves is reasonable. Therefore, in the name of "transparency", they are pushing for banks to absorb losses on a "pay as you go" basis. Long ago bankers and bank regulators learned that this was unwise in the banking business, both for the safety of individual banks and because such a policy would tend to exacerbate downturns in the economic cycle.

So, when the AICPA issued a proposal in 2003 designed to move toward their objectives, the federal bank regulators responded with strong opposition. In a letter dated October 6, 2003, the Agencies recognized that by requiring an unreasonable degree of specificity and reliance upon historical data (especially for good community banks in good times), this requirement would "cause financial institutions to maintain their loan loss allowances at inappropriate levels" and "overly constrain the use of expert credit judgment and 'unallocated' amounts and imply an artificial degree of precision in the loss estimation process."

We wholeheartedly agree with the Agencies' response on this issue. The AICPA subsequently abandoned the proposal early in 2005, but the accounting industry did not give up the cause. Outside the Beltway, audit firms have continued to push their clients toward greater specificity to justify holding reserves, creeping ever closer to the rejected "incurred loss" model. Audit firms in the field have also pushed bank clients toward lower and lower

levels of "unallocated" reserves. For good banks in good times, with little or no credit loss experience, this trend is a recipe for disaster. Yet audit firms tell their bank clients that, no matter what the regulators say, this is the direction that we have to go or else both the audit firms and publicly-held banks risk criticism from the SEC.

If bank regulators now require community banks with a large percentage of real estate loans to hold unreasonably high levels of reserves, while accounting firms simultaneously use the power of their audit opinion to require unreasonably low levels of reserves, community banks may soon be forced to choose between regulatory criticism and a certified financial statement. For both bankers and bank regulators, this is not the direction we should be going.

The amount of time, money, effort  
and paperwork that community banks  
should be required to do to  
disprove the assumption that they  
have an unsafe "concentration"  
of real estate loans

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We agree that banks should be required to maintain a loan portfolio stratification analysis in order to track and pay attention to the possible development of any legitimate concentrations of credit risk. We presently maintain one, and we readily concede to you that we need to continue to improve these analyses. Nonetheless, the extensive requirements set forth in the guidance sound nothing short of nightmarish for a community bank. Reports on market conditions, increased board oversight, new policies, strategic planning, quantifiable limits, contingency plans, feasibility studies, sensitivity analysis, stress-testing, tracking presales and on and on. This is a horrifying amount of ammunition for field examiners to use against community banks with limited staffs.

Again, this issue goes to the very heart of the future of community banking. Because community banks have been channeled into doing more commercial real estate lending, a great many of them would meet the thresholds proposed for treatment pursuant to this guidance. If the community banking segment of the industry is required to comply with a new regime of extremely burdensome requirements with which other financial institutions are not required to comply, community banking as we know it will be put in jeopardy.

### Summary

If you believe that our nation does not benefit from a large number of small community bank competitors, and that we would all be better served if banks were much larger and fewer in number, then this proposal is a good idea. It will surely make the safest and most profitable line of business left for community banks almost impossible for them to compete in profitably.

The regulatory paperwork, the board and management time spent, requirements to hold more capital than other competitors for the same loans, and the required limitations on safe, profitable business will all cause most community banks to become too unprofitable to satisfy investors and, therefore, to merge out of existence.

If, on the other hand, you think that our nation's small businesses and consumers benefit from the increased competition and choice created by community banks, and that our nation's unique network of community banking should continue, then this proposal should be abandoned or modified dramatically.

Thank you for your consideration of our views.

Very truly yours,

Bradley E. Rock